

Screening for Fraud in the Hedge Fund Industry

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This paper constructs a test for fraudulent managerial reporting in the hedge fund industry. We develop a model in which a manager reports satisfactory returns more readily than losses. This asymmetric smoothing generates conditional serial correlation and provides a red flag for fraud. Simulation evidence indicates that the statistical power of the test may be sufficient to deter fraudulent reporting. Empirical evidence shows that the probability of triggering a red flag is significantly related to the volatility and magnitude of investor cash flows, consistent with managerial smoothing in response to the risk of capital flight.